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C O N F I D E N T I A L SECTION 01 OF 04 BAGHDAD 002861

SIPDIS

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TAGS: [ECON](#) [ENRG](#) [MASS](#) [MOPS](#) [SENV](#) [EFIN](#) [PREL](#) [IZ](#)

SUBJECT: COSTS OF INTERDICTION TO IRAQI OIL SECTOR

REF: A. BAGHDAD 2694

[1](#)B. BAGHDAD 2787

[1](#)C. BAGHDAD 2790 AND PREVIOUS

Classified By: Charge d' Affaires David M. Satterfield for reasons 1.4
(b) and (d)

[1](#)1. (C) SUMMARY. The ITG is increasingly concerned about attacks to its oil infrastructure. Security has become a priority in recent ITG Cabinet-level meetings. DPM Chalabi has led extensive ministerial discussions in the National Energy Council, consisting of the Ministers of Oil, Electricity, Water Resources, Industry and Minerals, Finance, Interior, and Defense attempting to find a solution to the infrastructure security problems in Iraq. Based on our analysis, Iraq has lost over \$19 billion in oil export revenues, a significant portion of which is a direct result of insurgent activity from June 2003 through May 2005. Actual export volumes during this two-year period averaged 1.32 million barrels per day; well below our estimate of Iraq's export capacity of 2.4 million barrels per day. The primary causes of this reduction are the insurgency, looting, and an aged infrastructure. There were over 500 interdictions against oil production and pipeline systems between June 2003 and May 2005. The direct losses to the country are both the foregone export revenues and the cost of repairing the attack damage. Additional indirect losses include lost productivity, loss of potential gains from capital investments, and foregone infrastructure improvements. END SUMMARY

IRAQI GOVERNMENT CONCERNED ABOUT INFRASTRUCTURE SECURITY

[1](#)2. (C) Iraq continues to face enormous reconstruction and economic development needs. At the same time, its main source of revenue -- oil exports, accounting for 95 percent of revenues in the 2005 budget, according to Finance Minister Allawi, are dropping, primarily due to insurgent attacks. As a result, Iraq will need to address a potentially serious financing gap in 2005 - one that by some estimates could amount to \$2-3 billion. Against this backdrop, DPM Ahmed Chalabi has led extensive ministerial discussions in the National Energy Council (NEC), consisting of the Ministers of Oil (MOO), Electricity, Water Resources, Industry and Minerals, Finance, Interior, and Defense (MOD), in an attempt to find a way to better protect Iraq's oil infrastructure and increase production and exports. (reftels)

[1](#)3. (C) The NEC has attempted to find a least-cost solution to providing infrastructure security for the oil pipelines in the north. They have authorized the establishment, funding, and training of four Strategic Infrastructure Battalions (SIBS) under the supervision of the Ministry of Defense. These units are composed of tribal recruits from the vicinity of the Kirkuk to Bayji corridor. The ITG has had little success in improving infrastructure protection with these units, and the level of successful interdictions has increased. This has resulted in much talk in Baghdad between the NEC and the MOD, but no results in the field (REF B).

[1](#)4. (C) The DPM and the NEC ministers are frustrated with the MOD, and their inability to use the still few fully mission-capable Iraqi Army units to secure the infrastructure, which are deployed by MNF-I to protect Iraqi population centers from direct attacks by insurgents and terrorists. The DPM and NEC ministers do not want to use the tribal forces, and do not believe there will be any near-term success using tribal based forces in the form of the MOD plan based on the SIBS. (REF A, B, C). The DPM has frequently stated the cost for the lack of security in the form of lost export revenue exceeds \$500 million per month, and that security could be funded for a fraction of that amount. The DPM said he would consult with MNFI to request assistance to solve this problem. The Minister of Oil, in his meeting with the Charge' on July 1, repeated the theme of asking that trained Iraqi Army units currently under MNF-I's control be tasked to guard the northern oil infrastructure with MNFI assistance (septel). The NEC, on July 4, was informed by the MOD of a proposed plan to allocate Iraqi Army forces to assist in providing infrastructure security for the northern pipelines. This plan is under development at this time and proposes the use of two Iraqi Army battalions under the control of the 4th Iraqi Division in Kirkuk until new units can be formed and

trained (septel).

HISTORY OF INSURGENT ATTACKS ON OIL INFRASTRUCTURE

15. (C) Iraq's oil production capability in May 2003, at the conclusion of combat operations, was nearly what it was before the war began in March 2003. We did not intentionally target the oil infrastructure during the war, recognizing the importance of its contribution to stability and future reconstruction efforts. There were a few unintended exceptions including the bridge at Al Fathah, which carried the main northern export pipeline. We did bomb the bridge, and unfortunately interdicted the entire export capacity of the Kirkuk oil fields, as well as the supply fuel line for the Bayji power plant and refinery.

16. (C) The insurgent interdiction of the oil infrastructure began in earnest in May 2003 with attacks along the strategic pipelines in the south and north. From the beginning of the war through June 2003, looting of oil field and plant facilities, which has degraded Iraq's oil infrastructure and has contributed to the loss in export revenues, and worker absenteeism, attributed primarily to personal security concerns, disrupted exports particularly in the south. From June 2003 through May 2005 there were over 500 insurgent-related interdictions of oil infrastructure. Although the average number of monthly attacks declined between January and May 2005, the volume of lost exports increased, which seems to indicate the insurgents have become more effective, getting more 'buck' for their 'bang'.

17. (SBU) Oil production, pipeline, storage, and exporting facilities are anywhere from 25 to 70 years old and deteriorating. Iraq's oil infrastructure has undergone many years of frugal operating practices and a lack of maintenance. The dilapidated state of the infrastructure contributes to a lesser, but no less critical, degree to the drop in exports. It is difficult to isolate the effects of deterioration from the effects of insurgency activity. However, it would not be unrealistic to conclude that these systems could have been improved over this same time given a more secure environment.

VALUE OF IRAQ'S LOST EXPORTS

18. (C) We estimate the direct costs from lost revenue due to oil infrastructure interdiction (including looting, theft, and insurgent attacks) to be \$19.1 billion for the two years June 2003 through May 2005. Lost export revenues are \$19.1 billion and repair costs are \$64 million. Of \$19.1 billion, only 95 percent would have been available to the government of Iraq because of the requirement to pay 5 percent of revenues to Kuwait as war reparations.

IRAQ'S EXPORT POTENTIAL

19. (C) We estimate Iraq's total current potential export volume at 2.4 million barrels of oil per day (mbbl/d); 2.1 mbbl/d from southern exports and 0.3 mbbl/d from the northern route. We define potential exports as the volume of oil that Iraq could export given the following five assumptions: normal wear and tear, unlimited export demand, and an increased domestic consumption of crude oil. We assume that all planned maintenance, capital improvements, and investments were executed. We also assume that it is appropriate to use actual market prices for the period, concluding that world prices for Basra Light and Kirkuk crude would not be significantly different in either case. Note that if we arbitrarily reduced Iraq's potential exports by 20 percent, to 1.96 mbbl/d, losses still would have exceeded \$15 billion.

10. (SBU) We estimated potential export revenues by multiplying the potential monthly volumes for each type of oil by the monthly average of the daily actual prices of each, adding back marginal production cost, and subtracting the risk discount. Actual export revenues are estimated in the same manner by multiplying the actual monthly volumes for each type of oil by the monthly average of the daily actual prices of each. Finally, total lost export revenue is calculated by taking the difference between potential and actual export revenues, adding back lifting costs and subtracting the total risk discount. The Iraqi's have been required to offer a risk discount per barrel of oil during the period of insurgency. Estimates range from between \$0.20 and \$0.50 per barrel and are attribute to the unreliability of supply.

11. (C) Although they represent a small contribution to direct cost, repair costs are nonetheless relevant to our analysis. PCO estimates the value of the TD Williamson contract, which supported emergency repair of pipelines, at \$59M. After this contract expired, the Emergency Response Pipeline Repair Operation (ERPRO) paid for repairs, and PCO estimates the total receipts from those repairs are \$5M. Thus, the total spent by the USG for repairs is \$64M plus any expenses incurred by the Iraqi Ministry of Oil for which we do not have an estimate. Significantly, however, only 10 percent of all repairs were paid for by the USG. The Iraqis paid for the rest at a lower cost per repair.

INDIRECT COSTS

12. (SBU) The indirect costs of terrorist attacks on oil infrastructure may be difficult to identify and even more challenging to value, but they could also be greater in magnitude than the direct components. If we measured the effect of insurgent interdiction in terms of a loss in gross domestic product (GDP) rather than a loss in export revenues, the result would likely exceed our reported estimate because of the effect of a government spending multiplier. Productivity losses accumulate from the interruption of normal business operations and the requirement to divert labor and capital. There are potentially very large losses of gains from capital improvements and investment. Various sources, including the Ministry of Oil, indicated that planned but unrealized investments by domestic and foreign sources would have yielded significant increases in daily production. Most investors remain reluctant to commit exploration and development funds, in part, because of the lack of security.

FUTURE POTENTIAL

13. (C) The loss of so much revenue is almost impossible to compensate for. However, we can forecast the volume of exports that might be possible given an end to insurgent attacks and the completion of the Ministry of Oil's plans for infrastructure improvements. First, we estimate that if the northern strategic pipeline system is secured, then Iraq could immediately increase its exports by 300,000 barrels per day. In addition, the Minister of Oil estimated that the northern oil field systems could be improved to provide a gradual increase over the next 6 months of an additional 200,000 barrels per day, and that beginning in January 2006 it could do similar infrastructure improvements in the south that would eventually yield an additional 300,000 barrels of oil per day. This would yield 800,000 bbl/d of increased production available for export. (septel).

COMMENT

14. (C) COMMENT. From our study and analysis, the ITG is correct to be so deeply concerned with the lack of security for the key infrastructure of Iraq. In this brief analysis, we have attempted to quantify the lost revenues resulting from interdictions and the opportunity costs of a failure to adequately protect Iraq's oil infrastructure. The discussions at the NEC (reftels) demonstrate the Iraqi leadership's concern on the lack of infrastructure security and the costs to Iraq. The continued loss of oil revenues threatens the viability of Iraq's reconstruction, recovery and development -- and ultimately, its stability. END COMMENT

15. (U) REO BASRAH, REO HILLAH, REO MOSUL, REO KIRKUK minimize considered.
Satterfield